WAR PROFITS AND EXCESS PROFITS TAXES

So much ingenuity has been expended in the past by many generations of tax gatherers in devising ways and means for mulcting the taxpayer that the invention or discovery of a new tax is a natural cause for surprise. Yet the great war has apparently given the world a new tax, the excess profits tax. During past wars the sources of revenue which the new tax attempts to tap have, to be sure, been drawn upon. But they have been reached by means of the other forms of taxation, by some of the taxes upon property, upon income, and by consumption taxes.

This tax is new in the sense that it singles out a form of profits —war and excess profits—never heretofore separately distinguished as a tax base; and it is new, also, as to the social justification upon which it rests. The tax is levied on something conceived of as abnormal, and, in addition to the fiscal justification ever present in all taxes, there is a more or less distinct intent to give the public a share in the gains of "profiteering" as something transitory and abnormal as well as undesirable. Every other tax is based on something regarded as normal and permanent or at least recurrent and even where there is a regulative intent the regulation is designed and thought of as permanent and not transitory.

While we have no desire to overstress the newness of this tax it is perhaps of interest to consider whether the analogies to older taxes which have been suggested will hold. It has been suggested that the excess profits tax is analogous to the inheritance tax. Inheritance may be regarded as something unexpected and of the nature of a windfall, but certainly not as something abnormal. So this analogy goes but a little way. Again it has been suggested that there is an analogy to a special assessment for benefits accruing to some individual by reason of government action. But war was not declared for the purpose of creating profiteers or their profits, and the private benefits which occasion special assessments are not regarded as abnormal but as more or less designed. Again the analogy goes but a little way. Finally the tax is sometimes thought of as analogous to "unearned increment value" taxes. The analogy here is closer. But it is valid only in so far as "unearned" is interpreted to mean undeserved or abnormal, which is generally a strained meaning. An increment in the value

of land is a normal phenomenon. The tax has been called a variant of the income tax. But its sole relation to the income tax is that it uses a form of income as its base. There is otherwise not even a superficial resemblance.

The base of the tax is the excess of profit over an assumed normal profit. While the social mind had been prepared for the concept of this new tax base, by the subtle interpretation of unearned, in the term "unearned increment," as meaning undeserved, there has never been before such a complete, widespread, and almost unquestioning acceptance of the idea of unmerited profits as is involved in this tax. Astronomers and biologists for a long time past, and more lately social statisticians, have used for scientific analysis that form of average called the mode, but that idea has never been very clear or distinct in the popular mind. Yet here we have a legislatively expressed conviction supported by general assent of the people that there is a modal or normal profit to which the business man is fairly entitled, and that abnormal profits ought to be trimmed away as if a noxious growth, or at least made wholesome by a public use.

As a source of revenue in times of peace, even in "piping times of peace," the excess profits tax is a tax that is difficult to justify or defend. But as a war tax it has a few distinct merits. They are merits of expediency not of justice. It is effective in getting revenue. It garners for government some of the results of war inflation of prices.

In his first war budget speech in November, 1914, Mr. Lloyd George epitomized war taxation in the following remarkable statement:

> During the war and during the period of reconstruction . . . I think we can look forward to something like four or five years when the industries of this country will have the artificial stimulus which comes from these abnormal conditions . . . I want to impress upon the Committee with all the earnestness at my command that it is desirable that the nation, during this period of inflation, should raise as much money out of taxation as it can be induced to contribute. It is easier to raise taxes in a period of war and to lower them in a period of peace than it would be to raise even lower taxes in a period of peace. War is the time for sacrifice, and that makes a difference. It is a time when men know that they are expected to give up comforts, possessions, health, limb, life—all that the State requires in order to carry it through the hour of its trial. It is a time of danger, when men part willingly with anything in order to avert evils impeding on the country they love. Every twenty millions raised annually by taxation during

this period means four or five millions taken off the permanent burdens thereafter imposed on the country.

Inflation is a nasty by-product of war, a result of war spending, and of the errors of war finance. Inflation spreads its influence unevenly from class to class and from man to man, enriching some and impoverishing others. It is undoubtedly less disturbing, at a time when the least possible disturbance of industry is highly essential, to gather some of the needed extra revenues from those who profit by the irregular rise in prices than it would be to increase the general taxes. Those who get rich from war inflation can certainly well afford to pay war taxes. To use the phrase of the street, "a good way to get money for the government is to take it from those who have it."

The war profits tax, which soon evolved into the excess profits tax, was first proposed in 1915 in Denmark and Sweden. It was the large and extraordinary profits made by traders, especially by exporters, in supplying the needs of Germany which attracted attention and caught the ever greedy eye of the tax gatherer. These traders had exceptional opportunities for profit since their trade routes were intact while almost all other trade routes into Germany were cut off. Much of this rich trade was in foodstuffs and it was at first suggested that the tax be called the "goulash" or stew tax, implying that it was aimed at the German stew-pot. From here the tax spread with incredible rapidity to all parts of the world. Like the Spanish influenza it speedily infected all the belligerent countries on both sides of the fighting lines and also most neutral countries. Writing as early as March, 1917, J. C. Stamp was able to list thirteen countries which had been invaded by this tax.[1]

When first devised the tax was aimed only at those unusual or abnormal profits which were distinctly traceable to war conditions as a cause, or to "trading on the world's misery." So its very first victims were naturally the manufacturers of munitions. But other profits soared at the same time and the line of demarcation between "war profits" and other unusual profits proved exceedingly hard to draw. So *post hoc* easily became *propter hoc* and all profits were drawn into the net. While the war profits idea, and with it the abnormal profits concept, stuck fast all *large* profits, even though they might be quite normal, came under suspicion. Although *large* profits were fully covered by the income

[1] *Economic Journal,* March, 1917.

tax with its surtaxes, excess profits were often identified with large profits or gains. Two examples will show how the idea ran away from its own logic. Gold mining was at first included, although with a partial return to common sense it was later excluded. Now gold has a fixed price, which was not changed by the war. But all the expenses of mining, the cost of labor and of materials, went up. By no possibility could a gold mine make a war *profit;* quite the contrary, all gold miners suffered inevitably a war *loss.* Yet a rich "strike" was once considered an "excess profit." Again, one of the early American excess profits tax laws undertook to cover individuals, partnerships, and corporations, and included as taxable excess profits personal earnings in excess of $6,000, much to the surprise and indignation of many lawyers and other professional men, many of whom earned less rather than more during the war. By what reasoning $6,000 was hit upon as "normal" earnings is hard to say, the more so as the income tax, and the surtaxes covered the same "excess" earnings. Exceptions there were of many industries. Thus agriculture was in many countries exempt and in the United States the tax was finally confined to corporations.

So long as the emphasis lay on war profits, as the object of the tax, normal profits, the base from which the computation starts, was identified with a pre-war profit. The comparison was at first a direct one in absolute figures. If a given firm was making, before the war, $100,000 a year and in a year during the war made $150,000, then $50,000 was considered the war profit. Obviously this assumes that trade is along old lines, that there is no new plant and equipment and no change in products. But these assumptions were rarely true to life. How should one proceed if there were new capital investment? The answer was: allow the new capital the same *rate* of return as was earned before the war on the old capital, and tax only the excess over that amount. But suppose again it were an entirely new concern which was not in business before the war. What then? Here the answer was: allow an arbitrary rate of return on capital, arbitrarily declaring that rate to be the normal profit rate, and tax all over that as excess or war profits. In arriving at the arbitrary rate to be allowed the thought that there is a basic rate, a generally accepted due return on capital, which ought to be allowed, comes up at once. So any specific reference to pre-war actualities fell away and an *a priori* normal rate came in. Different countries fixed

different rates. But even after this due return rate had been satisfactorily, if arbitrarily, fixed, differences in risk rose up to perplex. A company with rapidly wasting assets cannot live on six, seven, or eight per cent annual profits. Capital will not go into highly speculative enterprises (motion pictures is the stock example) unless it has a chance at high profits to offset possible big losses. Some flexibility was necessary. America adopted the idea, in part at least, of the going rate in like concerns or like lines of business.

Great Britain gave the administration power to allow additional rates for risk or other peculiar reasons in selected exceptional businesses. Thus aircraft manufacture was allowed 9 per cent in addition to the general normal rate which was 6 per cent making 15 per cent the normal for this business. But more important than this, the ideas of depreciation, obsolescence, and depletion of capital were greatly extended, so that any excess profit or return on capital over the rigid normal assumed for all capital which might be assumed to be due to the special condition of a given industry were thus eliminated from profits and treated as expenses.

So kaleidoscopic and rapid were the changes in the forms of these taxes in different countries that an attempt to describe them, save at undue length, would be confusing in the extreme. We can only touch on some of the main features in the taxes of Great Britain and of the United States and shall confine our attention mainly to their final form, reached just after the armistice.

The "excess profits duty" of Great Britain was fixed in 1918 at 80 per cent of the amount by which the profits of the taxable year exceeded the "pre-war standard of profits." This "pre-war standard" had by this time settled down to mean one of two things. It was either the average profit of any two of the last three years prior to the war, or a statutory percentage of the capital at the end of the *last pre-war year*.[2] The taxpayer might use whichever basis was the larger. Obviously the larger the *normal* the smaller the *excess* would be. New capital and new concerns received the statutory allowance together with 3 per cent additional to cover the general risk of investment in a war period. It will be observed that the pre-war normal idea was preserved as far as pos-

[2] By applying the statutory rate to the pre-war capital, as the normal, Great Britain preserved the idea of a pre-war profit. The American idea, as we shall see, was of a pre-war normal *rate* of profit.

sible, although of course the arbitrary fixing of the statutory rate cut loose somewhat from actual pre-war facts. The statutory rate was fixed at 6 per cent for companies and at first 7 per cent then finally 8 per cent for other forms of organization. Mention has already been made of the special allowances which the referees might make for lines of business with peculiar risk or other conditions. It is obvious that the determination of invested capital takes on great significance. To avoid repetition this will be discussed under the American tax only. Although the general rules of income tax accounting prevailed, "profits" were by no means identical with "income." The subject of this tax was the proprietors' trading profit only.[3] Hence interest, annuities, and all proceeds of investment are excluded from the computation. It should be noted that the application of the statutory rate being to pre-war capital the tax is essentially a war profits tax, whether the constructive statutory or the actual pre-war profits are used as the normal. One grave difficulty of clinging so tenaciously to the pre-war basis was that as time passed and changes came that basis became more and more antiquated and out of proper comparison with present facts.

In the United States the "war-profits and excess-profits tax" reached its most highly developed form as applied to net income made during the year 1918. This tax had a forerunner in a tax of 12½ per cent on the profits of manufacturers of munitions levied under the act of 1916. A general war profits tax was imposed by the act of March, 1917, to be replaced by the excess profits tax in the act of October, 1917, both reappearing in new and consolidated form in the revenue law of 1918. An interesting feature, fortunately for one year only, has been already referred to. That was the extension of the tax to cover the excess of personal earnings not necessarily profits when over $6,000. This part of the tax of 1917 caused much discontent and was barely endured even as a war measure. Profits earned in 1919 and thereafter are taxable only under the excess profits tax; the so-called war profits provisions coming to an end in January, 1919. At the same time the rates of the excess profits tax were reduced.

The "war-profits and excess-profits tax" (act of 1918) applied only to corporations organized for profit.[4] As its name implies, it

[3] In this the British tax was unlike the American and was distinctly more logical.

[4] Gold mining was specifically exempt. We omit provisions exempting very

was a combination of two taxes and was theoretically separable into two parts. One was the excess profits tax proper, the other was the so-called war profits tax. The first was theoretically on the excess of profits over a pre-war average earnings. The two taxes were interwoven and interlaced. Unlike the British these taxes were based on net income from every source, as returned for income tax and not on profits only.

The two normals, which when increased by an arbitrary allowance of $3,000 for each were called "credits" and were deducted from profits in order to get the taxable item, differed in the following respects. The excess profits normal was 8 per cent of the capital used in the business for the taxable year.[5] The tax fell on the difference between the actual profit and this normal profit plus an arbitrary allowance of $3,000. The war profits normal was the average profits of the three pre-war years 1911, 1912, and 1913, plus or minus, as the case might be, 10 per cent of the increase or decrease in the invested capital of the taxable year over the average invested capital of the same three pre-war years. Of course, if there were no pre-war business or capital it was 10 per cent of the capital used in the taxable year, although to this administrative exceptions were permitted. To this normal an arbitrary allowance of $3,000 was added to make the technical pre-war credit or deduction. To repeat, the excess profits tax assumed that an 8 per cent return on capital is normal under all conditions. The war profits tax assumed that pre-war actual earnings are normal and when these were not ascertainable that 10 per cent on capital is a fair estimate in view of the high tax rate to be applied to the war profit.

The excess profits tax was graduated not by size of the excess but by *degree of excessivity* measured in terms of rate of profits to capital. Thus on that part of the taxable excess which did not exceed 20 per cent of the capital, the rate was 30 per cent; on all over 20 per cent of the capital, the rate was 65 per cent. Up to 20 per cent, then, the excess was considered mild; above that it

small profits, those giving abatements to incomes under $30,000 and the special provisions for profits under government contracts and for railroads and other utilities taken over by the government during the war, and some other minor adjustments.

[5] Note that unlike the British tax this cuts entirely loose from the pre-war concept; we have here a pure normal profit concept.

became more intense. The war profits tax was a straight 80 per cent of the excess of net income over the war profits credit.[6]

But the two taxes were not to be levied on any one company. In effect only that one was paid which was the larger of the two. The interweaving of the two taxes was, however, preserved. The excess profits tax was computed first. Then the war profits tax was computed. If the first exceeded the second it stood as the tax and the second was dropped or forgotten. But if the second exceeded the first the first was not simply dropped but was considered as being included in the second. It seems to have been the purpose of this provision to facilitate the repeal or dropping of the war profits tax without disturbing those parts of the law relating to the excess profits tax. The law reads as though the two were one tax with three grades, each having a different rate.[7]

6 The American war profits tax, although the rate was nominally the same, was heavier than the British in so far as it applied to all net income and not merely to profits. It was lighter in so far as the 10 per cent allowance exceeded the British 6 per cent allowance. In practice the heavy depreciation allowed probably made the American tax the lighter one.

7 At some time in the discussions over this tax and over the income tax someone hit upon the term bracket—apparently taken from printers' brackets [ ]—to describe the items entering into, and the calculations to be made in, any one distinct part of the computation of the tax. The same term is used in connection with the income tax to describe parts of the income reported for a fiscal year which parts (because the fiscal year did not correspond with the calendar year) were subject to a different tax rate. Once understood the term is useful for abbreviated expression much as slang is sometimes useful. Finally it crept into the law which provided for 1908 net income "a tax (the "war-profits and excess profits *tax*," not taxes) equal to the sum of the following:

"First Bracket: 30 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital:

"Second Bracket: 65 per centum of the amount of the net income in excess of 20 per centum of the invested capital;

"Third Bracket: The sum, if any, by which 80 per centum of the amount of the net income in excess of the war-profits credit (determined under section 311) exceeds the amount of the tax computed under the first and second brackets."

It will readily be seen that if 80 per cent of the amount of net income in excess of the war profits credit exceeded the amount of the tax computed under the first and second brackets, then whatever the 80 per cent amounted to was the total tax. For after taking away from that 80 per cent the entries found in the first two brackets, to get the amount to be entered in the third bracket, one then adds all three together again to get the total tax.

Beginning in 1920 and applying to the net income earned in 1919 the rates of the tax are to be 20 per cent for the excess

What all this sliding down hill and then running up again amounted to was merely to bring clearly before the eye the increase in the tax by reason of the war profits tax, and yet to preserve the fiction that there was only one tax. The fiction was useful only to facilitate the change in the succeeding year, to a single excess profits tax by the simple expedient of dropping out the third bracket. It is a triumph in the art of law writing worthy of the high repute for sagacity attributed by tradition to the Philadelphia lawyer.

Numerical example:

Data from books:		
Pre-war invested capital (average three years)		$50,000
Pre-war net income " " "		10,000
Invested capital, 1918		100,000
Net income, 1918		40,000
Computed items:		
Excess profits credit:		
Specific	$3,000	
8 per cent of $100,000	8,000	
	$11,000	
War profits credit:		
Specific	$3,000	
Pre-war net income	10,000	
10 per cent of increase of capital	5,000	
Capital	$18,000	
FIRST BRACKET		
20 per cent of 1918 capital is	$20,000	
Deduct excess profits credit	11,000	
	9,000	
(1) Tax at 30 per cent		2,700
SECOND BRACKET		
1918 income exceeded 20 per cent of 1918 capital by	$20,000	
(2) Tax at 65 per cent		13,000
Total tax (1) and (2)		15,700
THIRD BRACKET		
Total net income	$40,000	
Deduct war-profits credit	18,000	
Basis of computation at 80 per cent	$22,000	
80 per cent of $22,000 is	17,600	
Deduct sum of (1) and (2)	15,700	
(3) Tax in third bracket		1,900
Total tax (1), (2) and (3)		$17,600
Note the company also paid an income tax of 12 per cent on $40,000 less: $2,000 specific allowance plus the above taxes credit of $17,600 in all $19,700. That is 12 per cent of 20,300 or		2,436
Total of all taxes		$20,036

Other numerical examples abound in the textbooks and regulations.

up to 20 per cent of the invested capital and 40 per cent on the rest.

Two great logical difficulties of economic and legal interpretation of this tax at once presented themselves. These in turn gave rise to grave practical difficulties. Had it not been that patriotic fervor prevented any one from questioning these taxes they would doubtless have gone into court at once and have been tied up in an unending snarl of litigation. These two difficulties were: (1) what is invested capital and how can it be measured; (2) since the assumed universal normal of 8 per cent or 10 per cent could not, in the nature of things, recognize equally normal departures in special cases from the arbitrary general normal, what allowances for risk, depreciation, obsolescence, and depletion should be made, if any, to reach the proper normal in the special cases? The answers to these questions made to fit the peculiar concept of the excess profits tax have unfortunately been reflected in the interpretation and administration of the income tax with results that bid fair to be disastrous in that tax. The two questions may be considered together as essentially one.

The *value* of invested capital necessarily depends on the earnings. This is true of all businesses. But the difficulty is best seen in speculative businesses. No matter how costly a mine shaft and tunnels may have been they are as worthless as gopher holes if they tap no ore. Yet in this excess profits tax it is required to fix the value of invested capital independently of income or earnings because that value is going to be used in turn to compute the normal income. In short one has to fix the shadow in the absence of the body which casts the shadow. The thing cannot be done and in trying to do it the government has given an exhibition of how fast a puppy can turn round when he's trying to catch his own tail. The result was that invested capital came to be defined in substance as the amount paid in by the stockholders, whether originally or out of profits, in money or in property. Obviously this is approximately identical with the *value* of the capital in the case of a bank and of some similar staid and steady enterprises. But in all other cases it amounts to counting your chickens before they are hatched. Who can say what a dollar put into a street railway ten years ago is worth today?

The difficulties become acute in the case of mining and oil industries. A partial solution has been reached as a working basis. That solution was to take where possible the market value of the

property as of March 1, 1913, as a starting point, add at cost subsequent capital expenditures, and deduct ordinary wear and tear on the machinery, etc., and a cost allowance, estimated on the basis of what the ore body or sands contain, per ton of ore or barrel of oil extracted. Market value was, of course, originally based on future earnings, but, since it was a knowable fact prior to the present time, logic is not quite broken although badly strained by using this method. Estimates of what is under the ground are sheer guesses. The whole subject is full of trouble.

It is of course to the interest of the taxpayer to get as high a valuation of invested capital as possible, for then the depreciation and depletion allowances and also the normal profit allowances are larger. The excess profits tax is so heavy that the taxpayers strain themselves to get these items up. The result will be a permanent diminution of the income tax which might otherwise never have taken place.

It was remarked at the beginning of our discussion of this tax that astronomers and statisticians have developed a very definite scientific meaning for the concept of normal or modal. By the formal method of least squares and the less rigid short-cut application of the theory of probability a scientific mode or measure of the normal can be arrived at for any set of homogeneous items. It should be clear, however, that so far as this tax is concerned no scientific accuracy of method has been applied nor can one well be applied because the data are not homogeneous. What has been done has been to fix by statute what *it is believed ought* to be the normal. This congressional "ought" and the actual "is" do not agree, save in a few instances.

It has been remarked above that as a war tax the excess profits tax is not without some merit because it appropriates some of the profits of inflation. As a matter of fact its yield depends very largely on inflation, on paper profits reckoned in depreciated money, not necessarily corresponding to any real profits. This we may show more easily by an illustration than otherwise.

Let us assume there was a small crossroads grocery store incorporated, doing business at the same place before and during the war. We will assume further that it served in all years from 1911 to 1919 substantially the same old customers, with the same quantity (physical quantity) of groceries, from the same old shop with the same old equipment, and all the time with the same old clerks. In short what we aim to assume is that there has been

no change save in the prices of the goods bought and sold. In 1918 the store pays, let us say, twice as much money for the goods bought, and sells at twice the old retail prices, paying also double the old wages to its clerks. It costs, of course, two dollars in 1918 to stock a shelf which in 1911 could be filled for one dollar. We will assume that the entire stock turns over three times each year on a 10 per cent profit margin between cost and retail selling price. For simplicity we will assume that clerk hire and all general expenses are covered in merchandise cost, so that the 10 per cent is net income or profit. The concern does not borrow, but the additional turnover capital (in dollars) is advanced by the stockholders out of other private resources. We will assume that the premises cost $10,000 and have not been written up because such tangible property is slow to respond to inflation, and that the stock of goods carried represented in 1911 an average investment of $50,000. By the assumption then the profits before the war were $15,000 per annum. In 1918 the stock of goods represents an average of $100,000 and the profits for the year are therefore $30,000. There will be an excess profits tax of $8,260 to pay, but no war profits tax. We ignore the income tax of $2,368.80.

Analyzing the figures we have: profits before the war, $15,000 or 25 per cent on a capital of $60,000; profits 1918, $30,000 less tax of $8,260 or $21,740 which is a little less than 19 per cent on a capital of $110,000. The stockholders, despite the fact that they have put $50,000 more into the business, receive in dividends (out of which there is the income tax to pay) only $21,740, which has a purchasing power of only $10,870 as compared with their $15,000 before the war. By our assumption the stockholders would have been no better off in 1918 had they kept the whole $30,000 than they were in 1911, with dividends of $15,000, the changes being merely those necessary to make the figures correspond to the actual fall in the purchasing power of money. Yet they are assumed to be making an "excess of profits" and are taxed accordingly very heavily. It may be urged against this contention, of course, that the 25 per cent profit assumed in the example was always too high, and it is of course true that if the standard profit basis assumed were reduced to 8 per cent and a little over there would have been no tax. This contention is correct. But that very contention shows the nature of the tax. It is a tax on an assumed excessivity, not as so often alleged only on profiteering during the inflation period.

It is commonly asserted that the tax increases the cost of living and that it enters into prices carrying them high enough to give the trader his old rate of profit even after he has paid the new taxes.[8] If this be true, our corner grocery company would have had to be able to raise their prices, not merely 100 per cent as assumed, but enough more so that after paying the tax they would have had full $30,000 clear. Could they do it? This is a difficult question of shifting and incidence. The specific answer here turns largely on business psychology and will depend a good deal on the nature of the competition encountered by the business. If its immediate competitors were partnerships or individuals who did not have this tax to pay the situation would not be favorable for shifting the tax. New competition would, however, not be likely to arise. Competition acts slowly and it is distinctly not safe to assume that fear of competition would enter into the problem while prices were fluctuating so violently. It would have done the stockholders little or no good to have borrowed the additional capital needed even if they could have gotten it as low as 8 per cent, despite the fact that their added capital of $50,000 earned 13 per cent, for the borrowed money would not enter into the "invested capital" and the tax would have been much higher, enough so to more than wipe out the profit they might otherwise make by use of the borrowed funds. If the original conditions were such as to warrant 25 per cent profits, those conditions would, new competition being barred by the uncertainty and stress of war times, probably persist. Hence it seems highly probable that the company would feel forced to raise retail prices more than in proportion to the rise in wholesale prices. This it could do in part by raising the retail price of goods already in stock, whenever a rise in wholesale prices occurred, and in part by increasing the margin of profit used in marking its goods up. If, as is certainly likely to be the case, the rapid rise in prices curtailed purchases and lessened the volume of business in physical, not in money, measure, it might be possible for the company to shift the tax in part if not wholly to the consumer. Among the store's customers there would be some living on fixed incomes who would have to curtail purchases or buy only lower grades so the physical volume of business would naturally fall off. Our conclusion must be, therefore, that, while the tax is often a very real burden

8 We may overlook the fact that the tax was sprung as a surprise and not enacted until the books were closed for the year.

on the seller or manufacturer, it also raises prices to the consumers who furthermore suffer from being obliged to get along with less or poorer supplies. It is important to note that the period of inflation during which this tax has been in force is one in which the rate of business mortality, as measured by the liabilities of concerns which failed, has been remarkably low, compared even with prosperous pre-war years. This can hardly be explained on any other ground than that the heavy taxes, together with the ordinary wasteful costs which must be assumed to exist at all times in a fairly uniform ratio, have both been absorbed by rising prices.

One feature of the tax often commented on is its extreme inequality. If our corner grocery company had promptly disincorporated as early as 1917 it would have saved the whole tax. A partnership in the same business and of the same size of business on an opposite corner would not pay this tax. If the stockholders had not been in a position to put up the additional capital but had borrowed it, the tax would have jumped from $8,260 to $10,160 or nearly $2,000 more. That is, one of two concerns doing the same business may pay more than the other, the difference depending solely on the method of financing, which may or may not mean higher profits to the stockholders.

The extent to which business is discouraged by heavy and unequal taxation is often quite out of proportion to the burden or inequality of the taxation. It is a generally accepted truism that every tax tends to discourage the occurrence of the phenomenon on which it falls. If, as in Mexico at one time, the *sale* of cattle involved a heavy tax, cattle would not be *sold* if they could be otherwise used to advantage. This tendency never wholly absent is reduced to a minimum when the tax is regular and is expected to occur each year, and is operative at its maximum when the tax is regarded as temporary only. If a tax of 100 per cent is imposed on all buildings constructed this year, and it is known that there will be no tax next year, most buildings will be built next year. The excess profits tax was understood to be a war tax and it was confidently expected that it would be repealed as soon after the war as possible being meanwhile reduced or scaled down as fast as possible. This common understanding was confirmed in the federal revenue act of 1918 by actually setting forth the high rates for 1919 and the lower rates for 1920 and each year thereafter. This was a most egregious blunder—an attempt

by one party "to put one over" on the party coming into power, an attempt which instead "put one over" on the taxpayers and consumers. No concealment of the program was made. But no course more calculated to discourage production could have been devised. He who had standing timber did not cut enough to bring his profits into the excess class, even though by such restraint he could raise his price on the small amount cut far into the profiteering scale. So it was with him who had coal or oil in the ground or land for sale. By waiting a year an oil company could reduce its tax on the oil by a very considerable amount, more than enough to carry the oil in the ground. He who had leather for sale thought he might well leave it in the warehouse another year until taxes came down. So it was with every industry where postponement was possible. Only where production processes could be stopped solely at a loss greater than the taxes, or where the profits would not run into the taxable excess class, or where it was feared prices might fall and the profits be forever lost, or where the consumer could clearly be made to bear the whole tax, did production continue, and in still less cases did it make its normal expansion. This was disastrous from the point of view of general social welfare. The great post-war need was rapid restoration of production, and a rapid increase therein too.

A lumber company reasoned this way. If we stop cutting there is some loss, possibly offset in part by new growth; but if we cut this year a large part of our profits, ranging up to a maximum of 75 per cent, will go for taxes; if we wait a year the cumulative demand will hold prices up, and next year the taxes will be at least one third less; if we wait two years perhaps there will be no taxes. The company then makes a computation as to just how much it can cut and sell to best advantage this year, and next year in view of the tax. It is a foregone conclusion that the amount will be much less than the tempting prices would otherwise have brought forth. If it decides to cut enough to run into the excess profits it will be sure first that it will get a price large enough to cover the tax in its entirety. This explains how and why it is that the excess profits tax restrains production, enhances the high cost of living, and in general hampers industrial reconstruction. The interesting feature is that it is the anticipated removal of the tax quite as much as the high rate of the tax which causes this discouragement of industry.

This brings us to another interesting consideration. The tax

has been extolled as giving the government a share in the plunder of the profiteers and thus restoring to the people some of that which they had lost. In so far as the tax was unexpected and retroactive, being suddenly imposed, say in 1917, on the profits of 1916, this result is achieved. But after that, as we have seen, it can be largely shifted or evaded. Moreover, as it falls only on profits that are at once large, as well as excessive, it misses a very considerable amount of profiteering. There may be relatively very excessive profits on a small output, capital charges running over to later years' production, say of oil, and yet no tax will be paid unless the body of production be large enough to carry into the technical excess of the tax law.

The Secretary of the Treasury, the Hon. Carter Glass, reporting to Congress in December, 1919, said:

> . . . The Treasury's objections to the excess-profits tax even as a war expedient (in contradistinction to a war profits tax) have been repeatedly voiced before the committees of the Congress. Still more objectionable is the operation of the excess-profits tax in peace times. It encourages wasteful expenditure, puts a premium on overcapitalization, and a penalty on brains, energy and enterprise, discourages new ventures, and confirms old ventures in their monopolies. In many instances it acts as a consumption tax, is added to the cost of production upon which profits are figured in determining prices and has been, and will, so long as it is maintained upon the statute books, continue to be, a material factor in the increased cost of living.

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